

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-5977-98
GRShuler

date:

to: Chief, Examination Division, Ohio District
Attn: David Holscher, Ohio District Technical Coordinator

from: District Counsel, Ohio District

subject: Request for Technical Assistance; [REDACTED]

By memorandum you requested assistance in determining who must file tax returns to report interest income earned on an escrow account established in connection with a corporate stock sale. A second question, involving computation of gain or loss on the sale will be answered separately.

ISSUE

Does a fund established in connection with a corporate stock sale have to file income tax returns for its earnings? If so, should the filing be as a corporation or as a trust?

CONCLUSION

The fund is not required to file Federal income tax returns. The parent company selling off the subsidiary is responsible for reporting the interest income.

FACTS

[REDACTED] sold all the common stock of its wholly owned subsidiary, [REDACTED], to [REDACTED] on [REDACTED].

The Stock Purchase Agreement dated [REDACTED], stated the aggregate price to be \$[REDACTED] which included: (i) \$[REDACTED] payable to seller at closing, (ii) a promissory note for \$[REDACTED] plus or minus any increases or decreases as of the closing date, from the \$[REDACTED] inter-company debt and (iii) \$[REDACTED] (hereinafter "the Escrow Amount") to be paid to the [REDACTED] as Escrow Agent.

The Escrow Amount is to serve as security for [REDACTED]'s performance under the Purchase Agreement. The Escrow Agreement

ensures payment from [REDACTED] of the adjustment provided for in the Stock Purchase Agreement should the closing date net equity be finally determined to be less than \$[REDACTED] plus the amount of the Note. Similarly the buyer is liable for an upward adjustment should the closing date net equity exceed \$[REDACTED] plus the amount of the Note.

The escrow agent had limited administrative powers. The escrow agent was required to hold and invest the Escrow Amount but [REDACTED] had the right to direct investment. However, [REDACTED] had no right to receive any amounts until required adjustments were made or the approximate amount of potential adjustments was identified.

The Escrow Amount would be distributed when the seller and buyer reviewed and agreed to the closing date net equity. If either buyer or seller disagreed with the closing date net equity and notified the other party within fifteen days after the closing date statement, the parties were to attempt to resolve the dispute in good faith. If the buyer and seller failed to reconcile their differences, then a mutually agreed upon accounting firm would arbitrate the matter.

The buyer and the seller jointly made an election to treat the transaction as a sale of assets under I.R.C. § 338(h)(10). The adjusted basis of [REDACTED]'s assets exceeded the Modified Adjusted Selling Price (hereinafter "MADSP"). The transaction resulted in a loss to [REDACTED] with or without consideration of the Escrow Amount. The loss claimed on [REDACTED]'s [REDACTED] consolidated tax return does not include the Escrow Amount in the MADSP.

On or about [REDACTED], the buyer provided a closing data balance sheet which indicated [REDACTED]'s net equity had been overstated by \$[REDACTED]. Because such notice cast doubt on how much, if any, of the \$[REDACTED] [REDACTED] would ultimately receive, [REDACTED] treated the Escrow Amount as a contingent payment. This occurred prior to the end of [REDACTED]'s tax year. [REDACTED] did not include the \$[REDACTED] in the selling price of the subsidiary. We do not know how the buyer treated the sale.

Earlier this year an arbitrator issued a preliminary ruling on this dispute proposing [REDACTED] pay the buyer \$[REDACTED]. Currently, the ruling is on appeal and resolution is expected soon.

Neither [REDACTED] nor the escrow agent, [REDACTED] has reported the earnings from the escrow account on its income tax return.

ANALYSIS

Prior to 1986 a number of cases and rulings suggested that the earnings of a litigation settlement fund, receivership, or escrow account that did not qualify as a trust for Federal income tax purposes were not taxable until the identity of the person entitled to receive the income could be determined. See, e.g., North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932); Rev. Rul. 71-119, 1971-1 C.B. 163; Rev. Rul. 70-567, 1970-2 C.B. 133.

I.R.C. § 468B was enacted as part of the Tax Reform Act of 1986, Pub. L. 99-514, § 1807(a)(7), 100 Stat. 2814. The statute provides that a designated settlement fund is a separate taxable entity subject to current taxation on its net income at the maximum fiduciary rate. A provision relating to escrow accounts, settlement funds, and similar funds was incorporated in the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, § 1018(f)(5)(A), 102 Stat. 3582, and was codified as § 468B(g) which provides:

Nothing in any provision of law shall be construed as providing that an escrow account, settlement fund or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

This section applies to all escrow accounts, settlement funds, or other similar funds established after August 16, 1986.

In 1992 final regulations were issued. T.D. 8459, 1993-1 C.B. 68. The scope of the regulations is limited to certain types of litigation settlement funds. The regulations provide rules for designated settlement funds, and added a definition as well as rules for the treatment of qualified settlement funds.

In this case, the escrow account is not a designated settlement fund because it was not established to extinguish a liability of the payor that arose from a tort. Likewise, the escrow account is not a qualified settlement trust because it fails to meet the requirements of Treas. Reg. § 1.468B-1. The escrow account was not established pursuant to a court order or subject to the continuing jurisdiction of a court.

The escrow account was established and funded by the parties for the sole purpose of serving as security for [REDACTED]'s performance under the Purchase Agreement. The regulations do not address any such "other" funds. Nevertheless, I.R.C. § 468B(g) requires current taxation of the fund earnings as they accrue.

Whether the escrow holder would be required to file a return depends on whether it is a fiduciary. If the escrow holder was acting as a fiduciary, it should have filed and reported the interest.

Section 7701(a)(6) defines a fiduciary as a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in a fiduciary capacity for any person. A fiduciary is a person who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest, or receives and controls income of another. Treas. Reg. § 301.7701-6(b).

Revenue Ruling 69-300, 1969-1 C.B. 167, holds that a bank is a fiduciary when it is granted broad discretionary powers of administration and management. However, a bank is not a receiver or fiduciary merely because it is appointed as custodian.

A bank which acted as escrow agent with no authority to administer the funds or to disburse the funds without a court order was not required to file Form 1041 reporting interest on the funds in the account. Rev. Rul. 70-567, 1970-2 C.B. 133.

If the bank is merely holding the money and paying interest on that money, the bank is not a fiduciary. Rev. Rul. 82-177, 1982-2 C.B. 365. Where a bank is not a fiduciary, it is not required to file Form 1041.

In the present case, the escrow account was established for the purpose of protecting and conserving funds for the satisfaction of [REDACTED]'s obligations to sell all the stock of its wholly owned subsidiary, [REDACTED], to [REDACTED]. [REDACTED] transferred \$[REDACTED] to the escrow agent. The account functioned as a reserve fund, set aside by [REDACTED] to satisfy its business liabilities that may arise at a later point in time.

The escrow agent had purely administrative powers and no discretionary powers. The escrow agent could take no action except under the Escrow Agreement or pursuant to the order of a court with jurisdiction. The escrow agent exercised limited discretion over the investment of the Escrow Amount but [REDACTED] had the authority to direct the investment. The escrow account is invested and earns income that is accumulated on [REDACTED]'s behalf. Therefore, the escrow arrangement was an agency relationship. For that reason, the interest income earned by the escrow account is income to [REDACTED] for the taxable year it is earned.

SUMMARY

Section 468B(g) states that an escrow account is subject to current income tax. Although the escrow account does not qualify as a designated settlement fund or a qualified settlement fund under 468B(g) that does not preclude current taxation of the interest income. The interest income earned by the escrow account is income to [REDACTED] for the taxable year it is earned.

This memorandum is subject to post-review by the Office of Chief Counsel, under CCDM (35)3(19)4. We will inform you of any modification of this advice.

If you have any questions, please call Gary R. Shuler, Jr. of this office at (513)-684-3211.

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